CHAPTER 2

MORTGAGE CREDIT ANALYSIS

2-1 OVERVIEW. The purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine if it is sufficient collateral. The "Four C's of Credit" (Credit history, Capacity to repay, Cash to close, and the Collateral) are evaluated during the underwriting process.

This chapter on mortgage credit analysis describes procedures for evaluating the credit history, the borrower's capacity to make payments, and whether sufficient cash assets are available to close the mortgage. It provides the requirements on the types of income that may be considered in qualifying the borrower, the liabilities that must be included in the determining creditworthiness, and the debt-to-income ratios and compensating factors used in the underwriting process. These underwriting instructions are FHA's "base-line" credit policies. For those lenders using FHA-approved automated underwriting systems (AUS) or those employing FHA's TOTAL mortgage scorecard, there will be a considerable number of revisions to these policies, including documentation requirements, as described in other FHA issuances.

2-2 MORTGAGE ELIGIBILITY (BORROWERS). Generally, we will insure mortgages made to individuals only. Under the conditions described in Chapter 1, we will also insure mortgages made to state and local government agencies and approved nonprofit organizations.

A. Borrowers, Co-Borrowers and Co-Signers. Borrowers and Co-borrowers take title to the property and are obligated on the mortgage note and must also sign the security instrument. The co-borrower's income, assets, liabilities, and credit history are considered in determining creditworthiness.

Co-signers do not hold ownership interest in a property, but are liable for repaying the obligation and must sign all documents with the exception of the security instruments. The co-signer's income, assets, liabilities, and credit history are considered in determining creditworthiness for the mortgage and the co-signer must complete and sign the loan application.

We do not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments.

The following conditions also apply to co-borrower and co-signer eligibility:

1. A co-borrower or a co-signer may not be a party that has a financial interest in the transaction, such as the seller, builder, real estate agent, etc. Exceptions may be granted if the seller and co-borrower/co-signer is related to the owner by blood, marriage or law.

2. An individual signing the loan application must not be otherwise ineligible for participation. (See paragraph 2-5).

3. Unless otherwise exempted (e.g., military service with overseas assignments, U.S. citizens living abroad), any non-occupying co-borrowers or co-signers must have a principal residence in the United States.

All references to co-borrowers – including the 75 percent LTV limits (paragraph 1-8(B)), etc. – apply equally to co-signers (except co-signers do not take title to the property or sign the security instruments).

B. **<u>Citizenship and Immigration Status.</u>** Citizenship of the United States is not required for eligibility. When a mortgage loan applicant indicates on the loan application that he or she holds something other than U.S. citizenship, the lender must determine residency status from the documentation provided by the borrower.

<u>*Lawful Permanent Resident Alien*s</u>: For those borrowers with *lawful permanent resident alien* status, FHA will insure the mortgage under the same terms and conditions as U.S. citizens. The lender must document the mortgage file with evidence of permanent residency and indicate on the Uniform Residential Loan Application (URLA) that the borrower is a lawful permanent resident alien. Evidence of lawful permanent residency is issued by the Bureau of Citizenship and Immigration Services (BCIS) (formerly the Immigration and Naturalization Service) within the Department of Homeland Security.

<u>*Non-Permanent Resident Aliens*</u>: FHA will also insure a mortgage made to a *non-permanent resident alien* provided that the property will be the borrower's principal residence, the borrower has a valid SSN, and the borrower is eligible to work in the U.S. as evidenced by an Employment Authorization Document (EAD) issued by BCIS. If the authorization for temporary residency status will expire within one year and a prior history of residency status renewals exists, the lender may assume continuation will be granted. If there are no prior renewals, the lender must determine the likelihood of renewal, based on information from the BCIS.

Although social security cards may indicate work status, such as “not valid for work purposes,” an individual’s work status may change without the change being reflected on the actual social security card. Therefore, the social security card is not to be used as evidence of work status for non-permanent resident aliens; the BCIS employment authorization document is to be used instead.

Non-U.S. Citizens with no lawful residency in the U.S. are not eligible for FHA-insured mortgages.

C. **Borrower's Age.** There is no *maximum* age limit for a borrower. The minimum age is the age at which the mortgage note can be enforced legally in the state or other jurisdiction in which the property is located.

D. **Non-Purchasing Spouses.** If required by state law in order to perfect a valid and enforceable first lien, the non-purchasing spouse may be required to sign either the security instrument or documentation evidencing that he or she is relinquishing all rights to the property. If the non-purchasing spouse executes the security instrument for such reasons, he or she is not considered a borrower for our purposes and need not sign the loan application. In all other cases, the non-purchasing spouse is not to appear on the security instrument or otherwise take title to the property at loan settlement.

Where there are non-purchasing spouses who sign security instruments relinquishing their rights to the property pursuant to applicable state laws, these non-purchasing spouses do not have to sign the mortgage note. Signing the security instrument for such purposes does not make the non-purchasing spouse a co-borrower.

Except for the obligations specifically excluded by state law, the debts of the non-purchasing spouse must be included in the borrower’s qualifying ratios if the borrower resides in a community property state or the property to be insured is located in a community property state. Although the non-purchasing spouse's credit history is not to be considered a reason for credit denial, a credit report that complies with the requirements of paragraph 2-4 must be obtained for the non-purchasing spouse in order to determine the debt-to-income ratio.

E. **Military Personnel.** Military personnel are considered occupant-owners and are eligible for maximum financing if a member of the immediate family will occupy the property as a principal residence, even if the service person is stationed elsewhere.

F. **Living Trusts.** Property held in a *living trust* is eligible for FHA mortgage insurance for owner-occupied property, as long as an individual borrower remains the beneficiary and occupies the property as a principal residence. The lender must be satisfied that the trust provides reasonable means to assure that the lender will be notified of any subsequent change of occupancy (for owner-occupant loans only) or transfer of beneficial interest. The trust must appear on the security instrument (i.e., mortgage, deed of trust, security deed). The individual borrower must appear on the security instrument when required to create a valid lien under state law; otherwise, the individual borrower is not required to appear. The owner-occupant, if any, and other borrower(s), if any, must appear on the note with the trust. The individual borrower(s) is not required to appear on the property deed or title.

SECTION 1: CREDIT HISTORY

2-3 ANALYZING THE BORROWER'S CREDIT. Past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. Conversely, if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan.

When analyzing a borrower's credit history, examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments. A period of financial difficulty in the past does not necessarily make the risk unacceptable if the borrower has maintained a good payment record for a considerable time period since the difficulty. When delinquent accounts are revealed, the lender must document their analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or disputes with creditors.

While *minor* derogatory information occurring two or more years in the past does not require explanation, *major* indications of derogatory credit–including judgments, collections, and any other recent credit problems–require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. We also recognize that some prospective borrowers may not have an established credit history. For those borrowers, and for those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The lender must document that the providers of non-traditional credit do, in fact, exist and verify the credit information. Documents confirming the existence of a non-traditional credit provider may include a public record from the state, county, or city records, or other means providing a similar level of objective confirmation. To verify the credit information, lenders must use a published address or telephone number for that creditor.

As an alternative, the lender may elect to use a non-traditional mortgage credit report developed by a credit-reporting agency, provided that the credit reporting agency has verified the existence of the credit providers and the lender verifies that the non-traditional credit was extended to the applicant. The lender must verify the credit using a published address or telephone number to make that verification.

The basic hierarchy of credit evaluation is the manner of payments made on previous housing expenses, including utilities, followed by the payment history of installment debts, and then revolving accounts. Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history, unless there is major derogatory credit on his or her revolving accounts.

When reviewing the borrower's credit and credit report, the lender must pay particular attention to the following:

A. **Previous Rental or Mortgage Payment History.** The payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period.

B. **Recent and/or Undisclosed Debts.** The lender must ascertain the purpose of any recent debts, as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, the borrower must provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days.

C. **Collections and Judgments.** Court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement. (An exception may be made if the borrower has agreed with the creditor to make regular and timely payments on the judgment and documentation is provided that the payments have been made in accordance with the agreement.) FHA does not require that collection accounts be paid off as a condition of mortgage approval. Collections and judgments indicate a borrower's regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage where the borrower has collection accounts or judgments. The borrower must explain in writing all collections and judgments.

D. **Previous Mortgage Foreclosure.** A borrower whose previous principal residence or other real property was foreclosed or has given a deed-in-lieu of foreclosure within the previous three years is generally not eligible for a new FHA-insured mortgage. However, if the foreclosure was the result of documented extenuating circumstances that were beyond the control of the borrower and the borrower has re-established good credit since the foreclosure, the lender may grant an exception to the three-year requirement. Extenuating circumstances include serious illness or death of a wage earner, but do not include the inability to sell the house because of a job transfer or relocation to another area.

E. **Bankruptcy.** A Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. Additionally, the borrower must have re-established good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs. An elapsed period of less than two years, but not less than 12 months, may be acceptable if the borrower can show that the bankruptcy was caused by extenuating circumstances beyond his or her control and has since exhibited a documented ability to manage his or her financial affairs in a responsible manner. Additionally, the lender must document that the borrower's current situation indicates that the events that led to the bankruptcy are not likely to recur.

A Chapter 13 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage provided the lender documents that one year of the payout period under the bankruptcy has elapsed and the borrower's payment performance has been satisfactory (i.e., all required payments made on time). In addition, the borrower must receive permission from the court to enter into the mortgage transaction.

F. **Consumer Credit Counseling Payment Plans.** Participation in a consumer credit counseling payment program does not disqualify a borrower from obtaining an FHA-insured mortgage provided the lender documents that one year of the pay-out period has elapsed under the plan and the borrower's payment performance has been satisfactory (i.e., all required payments made on time). In addition, the borrower must receive written permission from the counseling agency to enter into the mortgage transaction.

2-4 CREDIT REPORT REQUIREMENTS.

A. **Traditional Credit Reports.** Credit reports submitted with each loan must contain all credit available in the accessed repositories. They also must provide an account of all credit, residence history, and public records information available in the credit repositories of each borrower responsible for the mortgage debt. The minimum credit report required by FHA is a "three repository merged" credit report (TRMCR). A Residential Mortgage Credit Report (RMCR) from an independent consumer-reporting agency also may be used. One report is required for each borrower, or a joint report may be obtained for a married couple.

The following are requirements for traditional credit reports:

1. The TRMCR submitted must be an original received electronically and printed on the lender's printer or delivered by the credit-reporting agency. The report must not have whiteouts, erasures, or alterations. It must indicate the name, address, and telephone number of the consumer-reporting agency; and each account listed must show the primary repository from which the particular information was pulled. The name of the company ordering the report must be shown.

2. The credit report must include all credit and legal information not considered obsolete under the Fair Credit Reporting Act, including bankruptcies, judgments, law suits, foreclosures, and tax liens that have occurred within the last seven years. All inquiries made within the last 90 days must also be included on the report. Credit reports that fail to show bankruptcies, judgments, lawsuits, foreclosures and tax liens must be supplemented with a corrected report. Lenders must retain all copies of all credit reports and document in writing an analysis of the reasons for any discrepancies between the credit reports. If a lender receives any information inconsistent with the information on the credit report, the lender must reconcile the inconsistency.

3. The credit report must identify each borrower's name and social security number. For each debt listed, the report also must show the date the account was opened, the high credit amount, the required payment, the unpaid balance, and the payment history, as contained in the credit repositories. The report must be in an easy-to-read and understandable format, and it should not require code translations.

4. The lender must also develop credit information separately for any open debt that is listed on the loan application but not referenced on the credit report. Accounts listed as "rate by mail only" or "need written authorization" require separate written verification.

5. While the TRMCR should prove sufficient for processing most loan applications, the following circumstances require an RMCR:

    a. The borrower(s) disputes the ownership of accounts on the TRMCR; or
    b. The borrower(s) claims that collections, judgments, or liens listed as open on the TRMCR have been paid and cannot provide separate documentation supporting this claim; or

c. The borrower claims that certain debts shown on the TRMCR have different balances and/or payments and cannot provide current statements (less than 30 days old) attesting to this claim; or
d. The lender's underwriter determines that it would be prudent to use an RMCR in lieu of a TRMCR to underwrite the loan properly.

6. RMCRs must access at least two named repositories and meet all the requirements for the TRMCR, plus the following:

   a. Provide a detailed account of the borrower's employment history.
   b. Verify each borrower's current employment and income (if obtainable). It also must include a statement attesting to certification of employment and date verified. If this information is not obtained through an interview with the employer, the credit reporting agency must state why this action was not taken.
   c. Each account with a balance must have been checked with the creditor within 90 days of the credit report.

B. **<u>Credit Report Requirements (Non-Traditional).</u>** A Non-Traditional Mortgage Credit Report (NTMCR) is designed to assess the credit history of a borrower without the types of trade references normally appearing on a traditional credit report. It can be used either as a substitute for a TRMCR or an RMCR for a borrower without a credit history with traditional credit grantors or as a supplement to a traditional credit report having an insufficient number of trade items reported. A NTMCR may not, however, be used to enhance the credit history of a borrower with a poor payment record or to manufacture a credit report for a borrower without a verifiable credit history. It also may not be used to offset derogatory references found in the borrower's traditional credit, such as collections and judgments.

The following conditions apply when using non-traditional credit reporting:

1. If the information obtained through the standard credit report is not sufficient for the lender to make a prudent underwriting decision, the lenders may use a NTMCR developed by a credit-reporting agency that documents all non-traditional credit references. Otherwise, the lender must develop its own non-traditional credit history that is consistent with the requirements for credit reporting agencies described in paragraph 2-4.

2. The credit-reporting agency should consider only the types of credit that require the mortgage applicant to make periodic payments on a regular basis. These types of credit include rental housing; utilities (if not included in the rental payment); telephone service; cable television service; insurance payments (excluding those paid through payroll deductions), such as medical, automobile, life, household, and renter's insurance; payments to child care providers; school tuition; payments to local stores; payments for the uninsured portion of any medical bills; etc.

2-5 <u>ELIGIBILITY FOR FEDERALLY-RELATED CREDIT.</u> A borrower must be rejected if any of the following conditions apply:

A. <u>HUD Limited Denial of Participation (LDP) and the U.S. General Services Administration's "List of Parties Excluded from Federal Procurement and Non-Procurement Programs" (GSA List)</u> A person suspended, debarred, or otherwise excluded from participation in the Department's programs is not eligible to participate in FHA-insured mortgage transactions. The lender must examine HUD's LDP list and the government-wide General Services Administration's (GSA) "List of Parties Excluded from Federal Procurement or Nonprocurement Programs" and document this review on the HUD 92900-WS/92900-PUR. If the name of the borrower, seller, listing or selling real estate agents, or loan officer appears on either list, the application is not eligible for mortgage insurance. A lender may check HUD's LDP list by going to www.hud.gov and the Federal government's list of excluded parties by going to http://epls.arnet.gov. (An exception shall be made for a seller on the GSA list when the property being sold is the seller's principal residence.)

B. <u>Delinquent Federal Debts.</u> If the borrower, as revealed by public records, credit information, or HUD's Credit Alert Interactive Voice Response System (CAIVRS), is presently delinquent on any Federal debt (e.g., VA-guaranteed mortgage, Title I loan, Federal student loan, Small Business Administration loan, delinquent Federal taxes) or has a lien, including taxes, placed against his or her property for a debt owed to the U.S., the borrower is *not* eligible until the delinquent account is brought current, paid, otherwise satisfied, or a satisfactory repayment plan is made between the borrower and the Federal agency owed and is verified in writing. Tax liens may remain unpaid provided the lien holder subordinates the tax lien to the FHA-insured mortgage. If any regular payments are to be made, they must be included in the qualifying ratios.

Since the IRS routinely takes a second lien position without the necessity of independent documentation, eligibility for FHA mortgage insurance will not be jeopardized by outstanding IRS tax liens remaining on the property unless the lender has information that the IRS has demanded a first-lien position.

Although eligibility for an FHA-insured mortgage may be established by performing the actions described above, the overall analysis of the creditworthiness must include consideration of a borrower's previous failure to make payments to the Federal agency in the agreed-to manner and must document its analysis of how the previous failure does not represent a risk of mortgage default.

C. **<u>CAIVRS.</u>** HUD's CAIVRS is a Federal government-wide repository of information on those individuals with delinquent or defaulted Federal debt and on those for whom a payment of an insurance claim has occurred. Lenders must screen all borrowers, including nonprofit agencies acting as a borrower, using CAIVRS (except on streamline refinances). If CAIVRS indicates the borrower is presently delinquent or has had a claim paid within the previous three years on a loan made or insured by HUD on his or her behalf, the borrower is not eligible except as described below. Lenders access CAIVRS either through the FHA Connection or functional equivalent or by calling 301-344-4000 on a touch-tone telephone. Lenders must write the CAIVRS authorization code for each borrower on the HUD-92900-WS/92900-PUR. Exceptions to this rule may be granted under the following situations:

1. **<u>Assumptions.</u>** If the borrower sold the property, with or without a release of liability, to an individual who subsequently defaulted, the borrower is eligible, provided he or she can prove the loan was not in default at the time of assumption.

2. **<u>Divorce.</u>** A borrower may be eligible if the divorce decree or legal separation agreement awarded the property and responsibility for payment to the former spouse. However, if a claim was paid on a mortgage in default prior to the divorce, the borrower is not eligible.

3. **<u>Bankruptcy.</u>** When the property was included in a bankruptcy that was caused by circumstances beyond the borrower's control (such as the death of the principal wage earner or serious long-term uninsured illness), the borrower may be eligible if the borrower meets the requirements in Paragraph 2-3 E.

While FHA may delete erroneous information regarding a borrower falsely indicated as having defaulted on a FHA mortgage, such as incorrect social security number reporting, it will not remove correct CAIVRS information even if the borrower is judged eligible under the conditions described above.

Lenders may not rely upon a clear CAIVRS approval when in possession of independent evidence of delinquent federal obligations and must document the resolution of any conflicting information. If the lender has reason to believe the CAIVRS message is erroneous or needs to establish the date of claim payment, the lender must contact the appropriate HOC for instructions or documentation to support the borrower's eligibility. The appropriate HOC can provide information when the three-year waiting period will elapse or if the social security number in CAIVRS is erroneous. The HOC will also provide instructions to lenders regarding processing requirements for other HUD-related defaults and claims (e.g., Title I loans).

We cannot alter or delete CAIVRS information reported from other Federal agencies, such as the Department of Education, Veterans Affairs, etc. The borrower and/or the lender must contact those agencies to correct or remove erroneous or outdated information. We do not require a "clear" CAIVRS authorization number as a condition for mortgage endorsement, but the lender must document and justify its approval based on the exceptions described above.

SECTION 2: EFFECTIVE INCOME

The anticipated amount of income, and the likelihood of its continuance, must be established to determine a borrower's *capacity* to repay mortgage debt. Income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. This section describes acceptable types of income, procedures for calculating effective income, and requirements for establishing income stability.

2-6 **STABILITY OF INCOME.** We do not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent two full years. If a borrower indicates he or she was in school or in the military during any of this time, the borrower must provide evidence supporting this claim, such as college transcripts or discharge papers. The borrower also must explain any gaps in employment spanning one month or more. Allowances for seasonal employment, such as is typical in the building trades, etc., may be made if documented by the lender.

To analyze and document the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment. A borrower who changes jobs frequently within the same line of work, but continues to advance in income or benefits, should be considered favorably. In this analysis, *income* stability takes precedence over *job* stability.

In some cases, a borrower may have recently returned to the work force after an extended absence. In these circumstances, the borrower's income may be considered effective and stable provided the following conditions apply:

A. The borrower has been employed in the current job for six months or more, and

B. The borrower can document a two-year work history prior to the absence from the work force. Acceptable documentation includes traditional employment verifications, copies of W-2's or paystubs.

An example of an acceptable employment situation includes a person that took several years off of work to raise children and then returned to the workforce. Situations not meeting the criteria listed above may be considered as compensating factors only.

2-7 **SALARIES, WAGES, AND OTHER FORMS OF EFFECTIVE INCOME.** The income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the *first three years* of the mortgage loan. If the borrower intends to retire during this period, the effective income must be the amount of documented retirement benefits, social security payments, or other payments expected to be received in retirement. No inquiry may be made regarding possible future maternity leave.

In most cases, the borrower's income will be limited to salaries or wages. Income from other sources can be included as effective income with proper verification by the lender. Procedures for analyzing other acceptable income sources besides salaries and wages are described below:

A. **<u>Overtime and Bonus Income.</u>** Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

An earnings trend also must be established and documented for overtime and bonus income. If either type shows a continual decline, the lender must provide a sound rationalization in writing for including the income for borrower qualifying. If bonus income varies significantly from year to year, a period of more than two years must be used in calculating the average income.

B. **<u>Part-Time Income.</u>** Part-time/second job income, including employment in seasonal work, may be used in qualifying if the lender documents that the borrower has worked the part-time job uninterrupted for the past two years and will continue to do so. Seasonal employment (e.g., umpiring baseball games in summer, working at a department store during the holiday shopping season) is considered uninterrupted and may be used in qualifying if the lender documents that the borrower has worked the same type of job for the past two years and expects to be rehired during the next season. Income from a part-time position that has been received for less than two years may be included as effective income, provided the lender justifies and documents that the income's continuance is likely. Income from part-time positions not meeting these requirements may be considered as a compensating factor only.

For qualification purposes, *part-time income refers to jobs taken to supplement the borrower's income from regular employment* (i.e., a second job – not meaning primary jobs of less than 40 hours per week.) If a borrower's regular employment involves less than a typical 40-hour workweek, the stability of that income should be evaluated as any other regular, on-going primary employment. For example, a registered nurse may have worked 24 hours per week for the last year. Although this job requires less than 40 hours of work per week, it is the borrower's primary employment and is to be considered effective income.

We recognize that many low- and moderate-income families rely on part-time and seasonal income for day-to-day needs. Lenders must not restrict the consideration of such income sources in qualifying these borrowers.

C. **Military Income.** In addition to base pay, military personnel may be entitled to additional forms of pay. Income from variable housing allowances, clothing allowances, flight or hazard pay, rations, and proficiency pay is acceptable, provided its probability of continuance is verified in writing. An additional consideration may be the tax-exempt nature of some of these payments (see paragraph Q for additional information.)

D. **Commission Income.** Commission income must be averaged over the previous two years. The borrower must provide copies of signed tax returns for the last two years, along with the most recent pay stub. (Unreimbursed business expenses must be subtracted from gross income.) Individuals whose commission income shows a decrease from one year to the next require significant compensating factors to allow for loan approval. Borrowers with commission income received for more than one but less than two years may be considered favorably provided the underwriter is able to make a sound rationalization for acceptance and can document the likelihood of continuance.

Commissions earned for less than one year are not considered effective income. Exceptions may be made for situations in which the borrower's compensation was changed from a salary to commission within a similar position with the same employer. A borrower also may qualify when the portion of earnings *not* attributed to commissions would be sufficient to qualify the borrower for the mortgage.

E. **Retirement and Social Security Income.** Retirement and social security income require verification from the source (former employer, Social Security Administration) or federal tax returns. If any benefits expire within the first full three years, the income source may be considered only as a compensating factor.

F. **Alimony, Child Support, or Maintenance Income.** Income in this category may be considered as effective if such payments are likely to be consistently received for the first three years of the mortgage. The borrower must provide a copy of the final divorce decree, legal separation agreement, or voluntary payment agreement, *as well as* evidence that payments have been received during the last twelve months. Acceptable evidence of payment regularity includes cancelled checks, deposit slips, tax returns, and court records. Periods less than twelve months may be acceptable, provided the payer's ability and willingness to make timely payments is adequately documented by the lender.

G. **Notes Receivable.** A copy of the note must be presented to establish the amount and length of payment. The borrower also must provide evidence that these payments have been received consistently for the last twelve months, which may include deposit slips, cancelled checks, or tax returns. If the borrower is not the original payee on the note, the lender must also establish that the borrower is now a holder in due course and able to enforce the note.

H. **Interest and Dividends.** Interest and dividend income may be used, provided that documentation (tax returns or account statements) supports a two-year history of receipt. This income must be averaged over the two years. Any funds derived from these sources and required for the cash investment must be subtracted before the projected interest or dividend income is calculated.

I. **Mortgage Credit Certificates.** If a government entity subsidizes the mortgage payments, either through direct payments or through tax rebates, these payments can be considered as acceptable income if verified in writing. Either type of subsidy may be added to gross income or may be used to directly offset the mortgage payment before calculating the qualifying ratios.

J. **Employer Differential Payments.** If the employer subsidizes the mortgage payments through direct payments, the amount of the payments is considered gross income; it may not be used to offset the mortgage payment directly, even if the employer pays the servicing lender directly.

K. **VA Benefits.** Direct compensation, such as for a service-related disability, is acceptable, subject to documentation from the VA. Education benefits, used to offset education expenses, are not acceptable.

L. **Government Assistance Programs.** Income received from government assistance programs is acceptable, subject to documentation from the paying agency, provided the income is expected to continue at least three years. If the income is not expected to be received for at least three years, such income may be considered as a compensating factor. (Unemployment income must be documented for two years. Reasonable assurance of its continuance is also required. This requirement may apply to individuals employed on a seasonal basis, such as farm workers, resort employees, etc.)

M. **<u>Rental Income.</u>** Rent received for properties owned by the borrower is acceptable if the lender can document that the rental income is stable. Examples of stability may include a current lease, an agreement to lease, or a rental history over the previous 24 months that is free of unexplained gaps greater than three months. (Student, seasonal, or military renters, or property rehabilitation would provide such an explanation). A separate schedule of real estate is not required for rental properties, provided all properties are shown on the URLA.

If the borrower resides in one or more units of a multiple-unit property and charges rent to tenants of other units, that rent may be used for qualifying purposes. However, projected rent of additional units only and not the owner-occupied unit(s) may be considered gross income only after deducting the HOC's vacancy and maintenance factor. They may not be used as a direct offset to the mortgage payments.

Income from roommates in a single-family property to be occupied as the borrower's primary residence is not acceptable. Rental income from boarders is acceptable if the boarders are related by blood, marriage, or law. The rental income may be considered effective income if shown on the borrower's tax returns. Otherwise, the income only may be considered a compensating factor and must be documented adequately by the lender.

The following is required to verify all rental income:

1. **<u>Schedule E of IRS Form 1040.</u>** Depreciation may be added back to the net income or loss shown on Schedule E. Positive rental income is considered gross income for qualifying purposes; negative rental income must be treated as a recurring liability. The lender must be certain that the borrower still owns each property listed, by comparing the Schedule E with the real estate owned section of the residential loan application. (If the borrower in the same general area owns six or more units, a map disclosing the locations must be submitted evidencing compliance with FHA's seven-unit limitation. See paragraph 4-8 for additional information.)

2. **<u>Current Leases.</u>** If a property was acquired since the last income tax filing and is not shown on Schedule E, a current signed lease or other rental agreement must be provided. The gross rental amount must be reduced for vacancies and maintenance by 25 percent (or the percentage developed by the jurisdictional HOC), before subtracting PITI and any homeowners' association dues, etc., and applying the remainder to income (or recurring debts, if negative).

N. **Eligible Investment Properties.** If the property to be insured is an eligible investment property or sold through FHA's REO program, the following calculations of qualifying ratios apply:

1. Subtract the monthly payment (PITI) from the monthly net rental income of the subject property (gross rents, minus the 25 percent reduction or HOC's percentage reduction for vacancies and repairs). If this calculation yields a positive number, add the number to the borrower's monthly gross income. If the calculation results in a negative number, consider it a recurring monthly obligation; then
2. Calculate the mortgage payment-to-income ratio (top or front-end ratio) by dividing the borrower's current housing expense (principal residence) by the monthly gross income. (The monthly gross income will include any positive cash flow from the subject investment property.); and
3. Calculate the total fixed payment-to-income ratio (bottom or back-end ratio) by dividing the borrower's total monthly obligations, including any net loss from the subject investment property, by the borrower's total monthly gross income.

O. **Automobile Allowances and Expense Account Payments.** Only the amount by which the borrower's automobile allowance or expense account payments exceed actual expenditures may be considered income. The borrower must provide IRS Form 2106, Employee Business Expenses, for the previous two years to establish the amount of income that may be added to gross income. The borrower also must provide verification from the employer that these payments will continue. (If these calculations show a loss, that amount must be treated as a recurring debt. If the borrower uses the standard per-mile rate in calculating automobile expenses, as opposed to the actual cost method, the portion that the IRS considers depreciation may be added back to income.) Additionally, the borrower's monthly car payment must be treated as a recurring debt; it may not be offset by the car allowance.

P. **Trust Income.** Income from trusts may be used if guaranteed, constant payments will continue for at least the first three years of the mortgage term. Documentation is required and includes a copy of the Trust Agreement, or other trustee's statement, confirming amount, frequency of distribution, and duration of payments. Funds from the trust account also may be used for the required cash investment with adequate documentation.

Q. **Non-Taxable Income.** If a particular source of regular income is not subject to federal taxes (e.g., certain types of disability and public assistance payments, military allowances), the amount of continuing tax savings attributable to the non-taxable income source may be added to the borrower's gross income. The percentage of income that may be added may not exceed the appropriate tax rate for that income amount, and no additional allowances for dependents are acceptable. The lender must document and support the adjustments (the amount the income is "grossed up") made for any non-taxable income source. Child support income cannot be grossed up. The lender should use the tax rate used to calculate last year's income tax for the borrower. If the borrower is not required to file a federal income tax return, the tax rate to use is 25 percent.

R. **Projected Income.** Projected or hypothetical income is not acceptable for qualifying purposes. However, exceptions are permitted to this rule for income from cost-of-living adjustments, performance raises, bonuses, etc., which are both verified by the employer in writing and scheduled to begin within 60 days of loan closing.

If a borrower is about to start a new job and has a guaranteed, non-revocable contract for employment that will begin within 60 days of loan closing, the income is acceptable for qualifying purposes. The lender also *must* verify that the borrower will have sufficient income or cash reserves to support the mortgage payments and any other obligations during the interim between loan closing and the start of employment. (This condition may be appropriate for situations such as teachers whose contracts will begin with the new school year, or physicians who will begin residency after the loan is scheduled to close.) However, if the loan will close more than 60 days before the borrower's employment begins, the loan is *not eligible for endorsement* until the lender provides a pay stub or other acceptable evidence that the borrower has begun the new job.

2-8 **EMPLOYMENT BY FAMILY-OWNED BUSINESSES.** Borrowers employed at businesses owned by their family member(s) are required to provide additional income documentation. These borrowers must provide the normal verification of employment, pay stubs, and evidence that they are not an owner of the business. This evidence may include copies of the borrower's signed personal tax returns or a signed copy of the corporate tax return showing ownership percentages.

2-9 **SELF-EMPLOYED BORROWERS.** A borrower with a 25 percent or greater ownership interest in a business is considered self-employed for FHA mortgage loan underwriting purposes.

The following conditions apply to underwriting self-employed borrowers:

A. **Minimum Length of Self-Employment.** Income from self-employment is considered stable and effective if the borrower has been self-employed for two or more years. The high probability of failure during the first few years of a business makes the following requirements necessary for individuals who have been self-employed less than two years:

1. **Between One and Two Years.** An individual self-employed between one and two years must have at least two years of documented previous successful employment (or a combination of one year of employment and formal education or training) in the line of work in which the borrower is self-employed or in a related occupation to be eligible.

2. **Less than One Year.** The income from a borrower self-employed less than one year may not be considered effective income.

B. Documentation Requirements. The following documents are required from self-employed borrowers:

1. Signed and dated individual tax returns, plus all applicable schedules, for the most recent two years.

2. Signed copies of federal business income tax returns for the last two years, with all applicable schedules, if the business is a corporation, an "S" corporation, or a partnership.

3. A year-to-date profit-and-loss (P&L) statement and balance sheet.

4. A business credit report on corporations and "S" corporations.

C. Analyzing Income. The lender must establish the borrower's earnings trend over the previous two years but may average the income over three years, if all three years' tax returns are provided. If the borrower provides quarterly tax returns, the analysis can include income through the period covered by the tax filings. If the borrower is not subject to quarterly tax filings or does not file quarterly returns (Form IRS 1040 ES), the income shown on the P&L statement may be included in the analysis, *provided the income stream based on the P&L statement is consistent with the previous years' earnings*. If the P&L statements submitted for the current year show an income stream considerably greater than what is supported by the previous years' tax returns, the analysis of income must be predicated solely on the income verified through the tax returns.

To determine if the business can be expected to continue to generate sufficient income for the borrower's needs, lenders must analyze carefully the business's financial strength, the source of its income, and the general economic outlook for similar businesses in the area. Annual earnings that are stable or increasing are acceptable. Conversely, a borrower whose business shows a significant decline in income over the period analyzed is not acceptable, even if current income and debt ratios meet our guidelines.

There are four basic types of business structures: sole proprietorships, corporations; limited liability ("S" corporations); and partnerships. Each type requires slightly different forms of analysis.

The following provides additional information on analyzing tax returns:

1. **Individual Tax Returns (IRS Form 1040).** The amount shown on the IRS Form 1040 as "adjusted gross income" either must be increased or decreased, based on the lender's analysis of the individual tax returns and any related tax schedules. Particular attention must be paid to the following:

   a. Wages, Salaries, and Tips. An amount shown under this heading may indicate that the individual is a salaried employee of a corporation or has other sources of income. It also may indicate that the spouse is employed, in which case the income must be subtracted from the adjusted gross income in the analysis.

   b. Business Income or Loss (from Schedule C). The sole proprietorship income calculated on Schedule C is business income. Depreciation or depletion may be added back to adjusted gross income.

   c. Rents, Royalties, Partnerships, Etc. (from Schedule E). Any income received from rental properties or royalties may be used as income after adding back any depreciation shown on Schedule E.

   d. Capital Gain or Loss (from Schedule D). This transaction generally occurs only one time, and it should not be considered in determining effective income. However, if the business has a constant turnover of assets resulting in gains or losses, the capital gain or loss may be considered in determining the income, provided the borrower has at least three years' tax returns evidencing capital gains. An example includes an individual who purchases old houses, remodels them, and sells them for a profit.

   e. Interest and Dividend Income (from Schedule B). This income, which is taxable and tax-exempt, may be added back to the adjusted gross income only if it has been received for the past two years and is expected to continue.

(If the interest-bearing asset will be liquidated as a source of the cash investment, the lender must adjust accordingly.)

f. Farm Income or Loss (from Schedule F). Any depreciation shown on Schedule F may be added back to the adjusted gross income.

g. IRA Distributions, Pensions, Annuities, and Social Security Benefits. The non-taxable portion of these items may be added back to the adjusted gross income, if the income is expected to continue for the first three years of the mortgage.

h. Adjustments to Income. Certain adjustments to income shown on the IRS Form 1040 may be added back to the adjusted gross income. Among these adjustments are IRA and Keogh retirement deductions, penalties on early withdrawal of savings, health insurance deductions, and alimony payments.

i. Employee Business Expenses. These expenses are actual cash expenses that must be deducted from the borrower's adjusted gross income.

2. **Corporate Tax Returns (IRS Form 1120).** Corporations are state-chartered businesses owned by their stockholders. Compensation to its officers, generally in proportion to the percentage of ownership, is shown on the corporate tax returns and will appear on individual tax returns. If the borrower's percentage of ownership is not shown, it must be obtained separately from the corporation's accountant, with evidence that the borrower has the right to those funds. Once the adjusted business income is determined, it should be multiplied by the borrower's percentage of ownership in the business.

In analyzing the corporate tax returns, lenders must adjust for the following:

a. Depreciation and Depletion. The corporation's depreciation and depletion must be added back to after-tax income.

b. Taxable Income. Taxable income is the corporation's net income before federal taxes. It must be reduced by the tax liability.

c. <u>Fiscal Year vs. Calendar Year.</u> If the corporation operates on a fiscal year that is different from the calendar year, an adjustment must be made by the lender to relate corporate income to the individual tax return.

d. <u>Cash Withdrawals.</u> The borrower's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating.

3. **<u>"S" Corporation Tax Returns.</u>** An "S" corporation is generally a small, start-up business, with gains and losses passed on to stockholders in proportion to each stockholder's percentage of business ownership. The income for the owners comes from W-2 wages and is taxed at the individual rate.

   The "compensation of officers" line on the IRS Form 1120S is transferred to the borrower's IRS Form 1040. Both depreciation and depletion may be added back to income in proportion to the borrower's share of income. However, income also must be deducted proportionately by the total obligations payable by the corporation in less than one year. The borrower's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating and must be considered in the analysis.

4. **<u>Partnership Tax Returns.</u>** A partnership is formed when two or more individuals form a business and share in profits, losses, and responsibility for running the company. Each partner pays taxes on his or her proportionate share of the partnership's net income.

   Both general and limited partnerships report income on the IRS Form 1065; this form must be reviewed by the lender to assess the viability of the business. The partner's share of income is carried over to Schedule E of IRS Form 1040. Both depreciation and depletion may be added back to income in proportion to the borrower's share of income. However, income also must be deducted proportionately by the total obligations payable by the partnership in less than one year. The borrower's withdrawal of cash from the partnership may have a severe negative impact on the partnership's ability to continue operating and must be considered in the analysis.

SECTION 3: BORROWER'S CASH INVESTMENT IN THE PROPERTY

2-10 FUNDS TO CLOSE. The cash investment in the property must equal the difference between the amount of the insured mortgage, excluding any upfront MIP, and the total cost to acquire the property including prepaid expenses and closing costs as described in paragraph 1-9.

All funds for the borrower's investment in the property must be verified and documented. Acceptable sources of these funds include the following:

A. Earnest Money Deposit. If the amount of the earnest money deposit exceeds 2 percent of the sales price *or* appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit-holder acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made the average balance was sufficient to cover the amount of the earnest money deposit.

B. Savings and Checking Accounts. A verification of deposit (VOD), along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.

C. Gift Funds. An outright gift of the cash investment is acceptable if the donor is the borrower's relative, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined and documented interest in the borrower. The gift donor may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder, or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. No repayment of the gift may be expected or implied. (As a rule, we are not concerned with how the donor obtains the gift funds provided they are not derived in any manner from a party to the sales transaction. Donors may borrow gift funds from any other acceptable source provided the mortgage borrowers are not obligors to any note to secure money borrowed to give the gift.) This rule also applies to properties of which the seller is a government agency selling foreclosed properties, such as the Veterans Administration or Rural Housing Services. Only family members may provide equity credit as a gift on a property being sold to other family members. These restrictions on gifts and equity credit may be waived by the jurisdictional HOC provided that the seller is contributing to or operating an acceptable affordable housing program.

FHA deems the payment of consumer debt by third parties to be an inducement to purchase. While FHA permits sellers and other parties to make contributions of up to six percent of the sales price of a property toward a buyer's actual closing costs and financing concessions, this policy applies exclusively to the provision of mortgage financing. Other expenses paid on behalf of the borrower must result in a dollar-for-dollar reduction to the sales price. The dollar-for-dollar reduction to the sales price also applies to gift funds not meeting the requirement that the gift be for downpayment assistance and is provided by an acceptable source. When someone other than a family member has paid off debts, the funds used to pay off the debt must be treated as an inducement to purchase and the sales price must be reduced by a dollar-for-dollar amount in calculating the maximum insurable mortgage.

Documentation Requirements. The lender must document the gift funds by obtaining a gift letter, signed by the donor and borrower, that specifies the dollar amount of the gift, states that no repayment is required, shows the donor’s name, address, telephone number and states the nature of the donor’s relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower, as follows:

1. If the gift funds are in the homebuyer's bank account, the lender must document the transfer of the funds from the donor to the homebuyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The homebuyer's deposit slip and bank statement that shows the deposit is also required.

2. If the gift funds are to be provided at closing:

    a. If the transfer of the gift funds is by certified check made on the donor's account, the lender must obtain a bank statement showing the withdrawal from the donor's account, as well as a copy of the certified check.

    b. If the donor purchased a cashier's check, money order, official check, or any other type of bank check as a means of transferring the gift funds, the donor must provide a withdrawal document or canceled check for the amount of the gift, showing that the funds came from the donor's personal account. If the donor borrowed the gift funds and cannot provide documentation from the bank or other savings account, the donor must provide written evidence that those funds were borrowed from an acceptable source, i.e., not from a party to the transaction, including the lender. "Cash on hand" is not an acceptable source of the donor's gift funds.

Regardless of when the gift funds are made available to the homebuyer, the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

NOTE: FHA does not "approve" down payment assistance programs in the form of gifts administered by charitable organizations (i.e., nonprofits). Mortgage lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. In addition, FHA does not allow nonprofit entities to provide gifts to homebuyers for the purpose of paying off installment loans, credit cards, collections, judgments, and similar debts.

D. **<u>Collateralized Loans.</u>** Funds can be borrowed for the total required investment as long as satisfactory evidence is provided that the funds are fully secured by investment accounts or real property. Such assets may include stocks, bonds, real estate (other than the property being purchased), etc.

In addition, certain types of loans secured against deposited funds, such as signature loans, the cash value of life insurance policies, loans secured by 401(k)s, etc., in which repayment may be obtained through extinguishing the asset; do not require consideration of a repayment for qualifying purposes. However, in such circumstances, the asset securing the loan may not be included as assets to close or otherwise considered as available to the borrower.

An independent third party must provide the borrowed funds. The seller, real estate agent or broker, lender, or other interested third party may not provide such funds. Unacceptable borrowed funds include signature loans, cash advances on credit cards, borrowing against household goods and furniture and other similar unsecured financing.

E. **Sales Proceeds.** The net proceeds from an arms-length sale of a currently owned property may be used for the cash investment on a new house. A fully executed HUD-1 Settlement Statement must be provided as satisfactory evidence of the cash sales proceeds accruing to the borrower. If the property has not sold by the time of underwriting, loan approval must be conditioned upon verifying the actual proceeds received by the borrower. The lender must document both the actual sale and the sufficiency of the net proceeds required for settlement.

F. **Trade Equity.** The borrower may agree to trade his or her real property to the seller as part of the cash investment. The amount of the borrower's equity contribution is determined by subtracting all liens against the property being traded (along with any real estate commission) from the lesser of that property's appraised value or sales/trade price.

Value must be determined by a residential appraisal no more than six months old. Evidence of ownership also is required. Additionally, if the property being traded has an FHA-insured mortgage, assumption processing requirements and restrictions apply (see Chapter 4 for additional information).

G. **Sale of Personal Property.** If the borrower intends to sell personal property items (cars, recreational vehicles, stamps, coins, baseball card collections, etc.) to obtain funds required for closing, the borrower must provide a satisfactory estimate of their worth, in addition to conclusive evidence the items have been sold. The estimated worth of the items being sold may be in the form of published value estimates, such as those issued by automobile dealers, philatelic or numismatic associations, or a separate written appraisal by a qualified appraiser with no financial interest in the loan transaction. Only the lesser of this estimate of value or the actual sales price is considered as assets to close.

H. **Employer's Guarantee Plans.** If the borrower’s employer guarantees to purchase the borrower's previous residence as the result of relocation, the borrower must submit evidence of the agreement and the net proceeds must be guaranteed.

I. **Employer Assistance Plans.** If the employer, to attract or retain valuable employees, pays the employee's closing costs, mortgage insurance premium, or any portion of the cash investment, this payment is considered employee compensation and no adjustment to the maximum mortgage amount is required. If the employer provides this benefit after loan settlement, the borrower must provide evidence of sufficient cash for closing. *A salary advance, however, cannot be considered as assets to close since it represents an unsecured loan*.

J. **Savings Bonds, Etc.** Government issued bonds are counted at original purchase price, unless eligibility for redemption and redemption value are confirmed. Actual receipt of funds at redemption must be verified.

K. **IRAs, Thrift Savings Plans, 401(k)s & Keogh Accounts.** Assets such as IRAs, thrift savings plans, and 401(k)s, etc., may be included in the underwriting analysis up to only *60 percent* of value unless the borrower provides conclusive evidence that a higher percentage may be withdrawn after subtracting any federal income tax and any withdrawal penalties. Evidence of redemption is required.

L. **Stocks and Bonds.** The monthly or quarterly statement provided by the stockbroker or financial institution managing the portfolio may be used to verify the value of these securities. Actual receipt of funds must be verified and documented.

M. **Cash Saved At Home.** Borrowers who have saved cash at home and are able to demonstrate adequately the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage. To include such funds in assessing the homebuyer's cash assets for closing, the money must be verified–whether deposited in a financial institution or held by the escrow/title company–and the borrower must provide satisfactory evidence of the ability to accumulate such savings.

The asset verification process requires the borrower to explain in writing how such funds were accumulated and the amount of time taken to do so. The lender must determine the reasonableness of the accumulation of the funds based on the borrower's income stream, the time period during which the funds were saved, the borrower's spending habits, documented expenses and the borrower's history of using financial institutions. (All other factors being equal, individuals with checking and/or savings accounts are less likely to save money at home than an individual with no history of such accounts.)

N. **Rent Credit.** The cumulative amount of the rental payments that exceed the appraiser's estimate of fair market rent may be considered accumulation of the borrower's cash investment. Both the rent-with-option-to-purchase agreement and the appraiser's estimate of market rent must be included in the endorsement package.

Conversely, if the sales agreement reveals that the renter has been living in the property (or one owned by the seller) rent-free, or that an agreement was made allowing the renter to occupy at a rental amount considerably below fair market value in anticipation of eventual purchase of the property, this situation must be treated as an inducement to purchase with an appropriate reduction to the mortgage. Exceptions may be granted in situations, such as when a builder fails to deliver a property at an agreed-to time and then permits the borrower to occupy that or another unit for less-than-market rent temporarily until construction is complete.

O. **Sweat Equity.** Labor performed or materials furnished by the borrower before closing, on the property being purchased, may be considered as the equivalent of a cash investment, to the extent of the estimated cost of the work or materials. (Sweat equity may be "gifted" subject to the gift requirements and additional requirements shown below.) Additionally, the following apply to sweat equity:

1. On existing construction, only the repairs or improvements listed on the appraisal are eligible for sweat equity. Any work completed or materials provided *before* the appraisal is made are not eligible. On proposed construction, the sales contract must indicate the tasks to be performed by the homebuyer during construction.

2. The borrower's labor may be considered as the equivalent of cash, if the borrower can demonstrate his or her ability to complete the work in a satisfactory manner. The lender must document the contributory value of the labor through either the appraiser's estimate or a cost estimating service.

3. Delayed work (on-site escrow), clean up, debris removal, and other general maintenance cannot be included as sweat equity.

4. There can be no cash back to the borrower in these transactions.

5. Sweat equity on a property other than the property being purchased is not acceptable. Compensation for work performed on other properties must be in cash and be properly documented.

6. Evidence of the source of funds used to purchase and the market value of the materials must be provided if the borrower furnishes these.

P. **Commission from Sale.** If the borrower is a licensed real estate agent entitled to a real estate commission from the sale of the property being purchased, that amount may be used for the cash investment with no adjustment to the maximum mortgage required. A family member entitled to the commission also may provide gift funds to the homebuyer.

Q. **Disaster Relief Grants and Loans.** Grants or loans from state and federal agencies [e.g., Federal Emergency Management Agency (FEMA)] that provide immediate housing assistance to individuals displaced due to natural disaster may be used for the borrower's cash investment. Secured or unsecured disaster relief loans administered by the Small Business Administration (SBA) also may be used. However, if the SBA loan will be secured against the property being purchased, it must be clearly subordinate to the FHA-insured mortgage. Any monthly payment arising from such a loan must be included in the qualifying ratios.

R. **Cash Accumulated with Private Savings Clubs.** Some borrowers may choose to use non-traditional methods of saving money by making deposits into private savings club. Often, these private savings clubs pool resources for use among the membership.

If a homebuyer claims that the cash to close an FHA-insured mortgage is from savings held with a private savings club, the borrower must be able to adequately document the accumulation of those assets with the club. While such clubs are not supervised banking institutions, the clubs must – at a minimum– have account ledgers, receipts from the club, verification from the club treasurer, and identification of the club so that the lender can reverify the information provided. The underwriter must be able to determine that it was reasonable for the borrower to have saved the money claimed and that there is no evidence these funds were borrowed with an expectation of repayment.

SECTION 4: LIABILITIES

2-11 **TYPES OF LIABILITIES.** The following are types of liabilities that must be considered in qualifying borrowers:

A. **Recurring Obligations.** The borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges *extending ten months or more*, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc. Debts lasting less than ten months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing.

The following additional information deals with revolving accounts and alimony payments:

1. Revolving Accounts. If the account shown on the credit report has an outstanding balance, monthly payments for qualifying purposes must be calculated at the greater of 5 percent of the balance or $10 (unless the account shows a specific minimum monthly payment).

2. Alimony. Because of the tax consequences of alimony payments, the lender may choose to treat the monthly alimony obligation as a reduction from the borrower's gross income in calculating qualifying ratios, rather than as a monthly obligation.

B. **Contingent Liabilities.** A contingent liability exists when an individual will be held responsible for payment of a debt, should another party, jointly or severally obligated, default on that payment. Unless the borrower can provide conclusive evidence from the debt holder that there is no possibility the debt holder will pursue debt collection against him or her should the other party default, the following rules apply to contingent liabilities:

1. Mortgage Assumptions**.** When a borrower remains obligated on an outstanding FHA-insured, VA-guaranteed, or conventional mortgage secured by a property that has been sold or traded within the last twelve months without a release of liability, or is to be sold on assumption *without* a release of liability being obtained, contingent liability must be considered unless:

a. The originating lender of the mortgage being underwritten obtains from the servicer of the assumed loan a payment history showing that mortgage has been current during the previous 12 months; or

b. An appraisal or closing statement from the sale of the property supports a value that results in a 75 percent LTV ratio [i.e., the outstanding balance on the mortgage loan (minus any UFMIP, if applicable) cannot exceed 75 percent of the appraised value or sales price].

2. Co-Signed Obligations. If the individual applying for an FHA-insured mortgage is a co-signer–or is otherwise co-obligated on a car loan, student loan, mortgage, or any other obligation – contingent liability applies unless the lender obtains documented proof that the primary obligor has been making payments during the previous 12 months on a regular basis and does not have a history of delinquent payments on the loan.

C. Projected Obligations. If a debt payment, such as a student loan, is scheduled to begin within twelve months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the borrower provides written evidence that the debt will be deferred to a period outside this timeframe. Similarly, balloon notes that come due within one year of loan closing must be considered in the underwriting analysis.

D. Obligations Not Considered Debt. Obligations not to be considered debt (or subtracted from gross income) include federal, state, and local taxes; FICA or other retirement contributions such as 401(k) accounts (including repayment of debt secured by these funds); commuting costs; union dues; open accounts with zero balances; automatic deductions to savings accounts; child care; and voluntary deductions.

SECTION 5: BORROWER QUALIFYING

The paragraphs below discuss debt-to-income ratios and the compensating factors that may be used to exceed the qualifying ratios. As evidenced by the description of compensating factors, ratios can be exceeded when significant compensating factors exist. We also do not set an arbitrary percentage that ratios may never exceed; however, the underwriter should judge the overall merits of the loan application and determine what compensating factors apply and the extent to which ratios may be exceeded.

Underwriting requires careful analysis of the many aspects of the mortgage. Each loan is a separate and unique transaction, and there may be other factors that demonstrate the borrowers' ability and willingness to make timely mortgage payments. There is a danger of "layering flexibilities" in assessing mortgage insurance risk, and simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting. The lender is responsible for adequately analyzing the probability that the borrower will be able to repay the mortgage obligation in accordance with the terms of the loan.

2-12 DEBT-TO-INCOME RATIOS. Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. The lender must compute two ratios:

A. Mortgage Payment Expense to Effective Income. If the total mortgage payment (principal and interest; escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing) does not exceed *29 percent of the gross effective income*, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable only if significant compensating factors as discussed in paragraph 2-13 are documented and are recorded on the mortgage credit analysis worksheet. Typically, for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio described below.

B. Total Fixed Payment to Effective Income. If the total of the mortgage payment and all recurring charges does not exceed *41 percent of the gross effective income*, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable only if significant compensating factors as discussed in paragraph 2-13 are documented and are recorded on the mortgage credit analysis worksheet.

2-13 COMPENSATING FACTORS. Compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed below. Underwriters must record on the "remarks" section of the HUD 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months.

B. The borrower makes a large downpayment (ten percent or more) toward the purchase of the property.

C. The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit.

D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.

E. The borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.

F. There is only a minimal increase in the borrower's housing expense.

G. The borrower has substantial documented cash reserves (at least three months' worth) after closing. In determining if an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily convertible to cash and can be done so absent retirement or job termination. Also see paragraph 2-10K.

Funds borrowed against these accounts may be used for loan closing, but are not to be considered as cash reserves. "Assets" such as equity in other properties and the proceeds from a cash-out refinance are not to be considered as cash reserves. Similarly, funds from gifts from any source are not to be included as cash reserves.

H. The borrower has substantial non-taxable income (if no adjustment was made previously in the ratio computations).

I. The borrower has a potential for increased earnings, as indicated by job training or education in the borrower's profession.

J. The home is being purchased as a result of relocation of the primary wage-earner, and the secondary wage-earner has an established history of employment, is expected to return to work, and reasonable prospects exist for securing employment in a similar occupation in the new area. The underwriter must document the availability of such possible employment.

MORTGAGE CREDIT ANALYSIS

SECTION 6: SPECIAL UNDERWRITING INSTRUCTIONS

2-14 Temporary Interest Rate Buydowns. Interest rate buydowns are designed to reduce the borrower's monthly payment during the early years of the mortgage and are permitted only on purchase transactions. Buydowns may only be used on fixed-rate mortgages.

Buydown funds may come from the seller, lender, borrower or other party. Funds from the seller or any other interested third party are considered seller contributions and must be included in the six percent limit on seller contributions (see paragraph 1-7A). Lenders must ensure that the funds described in the escrow agreement have been placed in escrow before or at closing and that the agreement meets the requirements described below.

Buydowns on eligible loans not meeting all the criteria described in paragraph A, below, may be considered only as compensating factors. However, all buydowns must comply with the escrow agreement requirements in paragraph B, below.

A. Underwriting Requirements for Qualifying Borrowers at the Buydown Interest Rate.

1. The mortgage must be a fixed rate loan on an owner occupied principal residence.

2. The buydown must not result in a reduction of more than two percentage points below the interest rate on the note.

3. The buydown must not result in more than a one-percentage point annual decrease in the interest rate. The borrower's payment may change only once a year.

B. Additional Interest Rate Buydown Instructions**.**

1. Lender-funded buydowns on fixed-rate purchase money mortgages through premium pricing are acceptable provided that the funds generated do not result in a reduction of more than 2 percentage points below the note rate.

2. The lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and likely lead to default. The underwriter must document that the borrower meets one of the following criteria:

a. The borrower has a potential for increased income that would offset the scheduled payment increases, as indicated by job training or education in the borrower's profession or by a history of advancement in the borrower's career with attendant increases in earnings.

b. The borrower has a demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses. This criterion also may include borrowers whose long-term debt, if any, will not extend beyond the term of the buydown agreement.

c. The borrower has substantial assets available to cushion the effect of the increased payments.

d. The cash investment made by the borrower substantially exceeds the minimum required.

3. Escrow Agreement Requirements. A copy of the escrow agreement, signed by the borrower and the provider of funds, must accompany the loan application. (The underwriter may condition the loan approval for an executed buydown agreement at closing.)

The following are requirements for the escrow agreement:

a. The agreement must provide that any escrow funds not distributed at the time the mortgage loan is prepaid be applied to the outstanding balance due on the mortgage. However, in the event of foreclosure, the claim for mortgage insurance benefits must be reduced by the amount remaining in the buydown escrow account.

b. The agreement must not permit reversion of undistributed escrow funds to the provider if the property is sold or the mortgage is prepaid in full. The agreement may provide that assistance payments continue to buyers who assume the mortgage. Unless the borrower establishes the escrow account, unexpended escrow funds may not be provided to the borrower in cash.

c. The escrow funds must be held in an escrow account by a financial institution supervised by a federal or state agency. Payments must be made by the escrow agent to the lender or its servicing agent. However, if the escrow payments are not received for any reason, it is the borrower's responsibility to make the total payment set forth in the mortgage note. FHA has no objection to the lender holding and administering the escrow funds for up to 60 days when there is an outstanding forward commitment to sell the mortgage.

2-15 ADJUSTABLE RATE MORTGAGES (ARMs). Borrowers must qualify for one-year ARMs using the mortgage payments based upon the contract or initial interest rate plus 1 percentage point (i.e., the anticipated maximum second-year interest rate) if the loan-to-value ratio is 95 percent or greater.

2-16 CONDOMINIUM UNITS–UTILITY EXPENSES. With proper documentation, such as that which is available from the utility company, the portion of a condominium fee that is clearly attributable to utilities may be subtracted from the Homeowners Association (HOA) dues before computing ratios.

2-17 CONSTRUCTION–PERMANENT MORTGAGE PROGRAM. A construction-permanent mortgage combines the features of a construction loan, a short-term interim loan for financing the cost of construction, and the traditional long-term permanent residential mortgage. For mortgage insurance and LTV purposes, we consider it to be a purchase transaction. The mortgage lender makes the loan directly to an approved borrower/homebuyer. There is one closing that occurs prior to the start of construction. At closing, funds are disbursed to cover purchase of the land, with the balance of the mortgage proceeds placed in an escrow account to be disbursed as construction progresses. *The loan is insured after construction is complete.*

Program Information.

A. **Disbursement of Funds.** It is the lender's responsibility to obtain written approval from the borrower before each draw payment is provided to the builder.

B. **Construction Period Fees.** Unless a separate agreement has been made specifying responsibility, construction loan interest, commitment fees, inspection fees, title update charges, real estate taxes, hazard insurance, and other financing charges incurred during the construction period are to be paid by the builder.

C. **Interest Rate.** The permanent mortgage loan interest is established at closing. However, a lender may offer a "ceiling/floor," whereby the borrower may "float" the interest rate during construction. The agreement must provide that, at the point of interest rate lock-in, the permanent mortgage will not exceed a specific maximum interest rate based on market fluctuations, as well as permit the borrower to lock-in at a lower rate depending on the market. The borrower must qualify for the mortgage at the maximum rate at which the permanent mortgage may be set.

D. **Disclosure.** The lender must provide a disclosure to the borrower explaining that the loan is not eligible for FHA mortgage insurance until after either a final inspection or issuance of a certificate of occupancy by the local governmental jurisdiction (whichever is later), and that FHA has no obligation until the mortgage is endorsed for insurance.

E. **Amortization.** Amortization must begin no later than the first of the month following 60 days from the date of either the final inspection or issuance of certificate of occupancy, whichever is later.

F. **Endorsement.** The lender must submit a request for endorsement after final inspection or issuance of certificate of occupancy (but within 60 days of the date the latter of these events occur). During construction, the loan is not FHA-insured.

G. **Remitting UFMIP.** FHA must receive the UFMIP within 15 days of closing or other time period as may be prescribed by FHA.

H. **Maximum Mortgage Amount.** The maximum mortgage amount is determined by applying LTV limits to the lesser of the appraised value or the acquisition cost. The acquisition cost includes the contractor's price to build, cost of the land, and allowable closing costs. (If the land has been owned more than six months or was received as an acceptable gift, the *value* of the land may be used instead of its cost.)

I. **Equity in the Land.** Equity in the land may be used for the borrower's cash investment. However, if the advancement of the permanent loan results in the borrower receiving cash out in excess of $250, the maximum LTV is limited to 85 percent. *If the contractor of the improvements is also the seller of the land, the total acquisition cost for maximum mortgage purposes is the purchase price to the borrower*.

J. **Other Underwriting Considerations.** The following criteria must be met for a loan to be considered a construction/permanent loan and to be eligible for FHA mortgage insurance:

The borrower must own or be purchasing the lot (or, if owned by the contractor, the lot must be included in the total contract price).

(1) The borrower must have secured or will secure the loan in his or her own name.

(2) The borrower has contracted with a builder to construct the improvement. (This program is not available to a borrower acting as his or her own general contractor, unless the borrower is a licensed builder by profession. In this case, the acquisition cost must be determined by the actual documented cost to construct the improvements.)

(3) The balance on the loan, when it is fully drawn, must be verified. The construction escrow account, if one was established, must be fully extinguished; any remaining funds must be applied to the outstanding balance of the permanent loan.

(4) If the borrower purchased the lot within the past 6 months, he or she must provide a copy of the HUD-1 or other settlement statement showing the acquisition cost. If the borrower owns the lot free-and-clear, the borrower must provide a copy of the Warranty Deed showing no vendor's lien, a copy of the release of lien, or a copy of the HUD-1 or other settlement statement showing ownership.

(5) If the initial draw on the loan was for the purpose of paying off the lot, a statement verifying the amount must be provided.

(6) The borrower must provide a copy of the fully executed sales agreement, which includes the contractor's price to build. (A Mechanic's and Material man’s lien is not sufficient.)

(7) If the borrower is including extras over and above the contract specification and/or is paying out-of-pocket costs over and above the interim loan, the borrower must provide a breakdown of the extras and the cost of each and canceled checks and paid receipts for all out-of-pocket construction costs.

K. **Documentation Requirements.** The loan is to be closed using standard FHA documentation, with the addition of a Construction Rider to the Note and a Construction Loan Agreement. These construction documents may be in any form acceptable to the lender, but they must provide that all special construction terms end when the construction loan converts to a permanent loan. After conversion, only the permanent loan terms (using standard documents) continue to be effective, thus making the permanent loan eligible for FHA mortgage insurance.

Prior to endorsement, the DE underwriter must be provided with the following:

1. Certification, signed by the borrower after conversion to the permanent loan, that the mortgaged property is free-and-clear of all liens other than the mortgage.

2. Verification that the construction loan has been fully drawn down.

3. Copies of canceled checks and paid receipts for all the borrower's out-of-pocket construction costs.

2-18 MORTGAGE INSURANCE FOR DISASTER VICTIMS [Section 203(h)]. FHA provides mortgage insurance to assist victims of Presidentially-declared disasters. Under this program, individuals or families whose residences were destroyed or damaged to such an extent that reconstruction or repair is necessary are eligible for 100 percent financing for the purchase of a home. The Federal Emergency Management Agency (FEMA) provides listings of the specific affected counties and cities and corresponding declaration dates. This information can be found on the Internet at http://www.fema.gov/disasters.

The procedures described are in effect whenever a disaster is declared by the President and remain in effect for one year from the date of the President's declaration.

A. Program and Underwriting Requirements.

The borrower's previous residence must have been in the disaster area and must have been destroyed or damaged to such an extent that reconstruction or replacement is necessary. The borrower must provide conclusive evidence of this fact. Documentation showing a permanent residence in the affected area before the disaster includes a valid driver's license, a voter registration card, utility bills, etc. Documentation regarding destruction of the residence includes an insurance report, an inspection report by an independent fee inspector or government agency, or conclusive photographic evidence showing the destruction or damage. The borrower may have been the owner of the property or a renter of the property affected.

The borrower is eligible for 100 percent financing of the sales price and no down payment is required. (However, closing costs and prepaid expenses not paid by the seller must be paid by the borrower in cash or paid through premium pricing.)
Maximum mortgage amounts are the same as for Section 203(b)/203(h). A list can be accessed from the lender Web page on HUD's Website at www.hud.gov or on FHA Connection at https://entp.hud.gov/clas/.

The program is limited to one-unit detached homes or units in an approved condominium project. "Spot units" in condominiums are eligible also. Two-, three-, and four-unit properties may not be purchased under the Section 203(h) program.

The borrower's mortgage loan application must be submitted to the lender within one year of the President's declaration of the disaster.

ARMS may be used with the Section 203(h) program.

B. **Using Section 203(k) with 203(h) for Rehabilitation Mortgages.** The requirement for a dwelling to be completed more than one year preceding the date of the application for mortgage insurance under Section 203(k) does not apply to properties in the disaster area. Damaged residences are eligible for Section 203(k) mortgage insurance regardless of the age of the property. The residence needs only to have been completed and ready for occupancy for eligibility under Section 203(k). The percentage of financing is determined by the type of mortgage being made (i.e., normal LTV ratios apply to Section 203(k) mortgages made in these areas).

Homes that have been demolished, or will be razed as part of the rehabilitation work, are eligible provided the existing foundation system is not affected and still will be used. The complete foundation system must remain in place.

2-19 **ENERGY-EFFICIENT HOMES (EEH).** The benchmark qualifying ratios may both be exceeded by up to 2 percentage points when the borrower is purchasing or refinancing an EEH. These higher housing expense- and obligations-to-income ratios are justified due to the anticipated energy costs savings and become 31 percent and 43 percent, respectively. The appropriate HOC determines if a property qualifies for EEH designation. The original documentation attesting to energy efficiency is required on resales.

All properties meeting the Council of American Building Officials (CABO) 1992 Model Energy Code (MEC) are considered energy efficient and eligible for the two percentage points increase in the qualifying ratios.

2-20 <u>ENERGY EFFICIENT MORTGAGE (EEM) PROGRAM.</u> The FHA EEM Program is for *existing* properties. An EEM recognizes the energy savings of a home that has "cost effective" energy saving improvements, which increase the energy efficiency of a home. Because the home is energy efficient, the occupant(s) will save on utility costs and, thus, be able to devote more income to the monthly mortgage payment. Energy efficiency improvements can include energy saving equipment and active and passive solar technologies.

Under the FHA EEM Program, a borrower can finance into the mortgage 100 percent of the cost of eligible energy efficient improvements, subject to certain dollar limitations, without an appraisal of the energy efficient improvements. To be eligible for inclusion into the mortgage, the energy efficient improvements must be "cost effective" (i.e., the total cost of the improvements, including maintenance costs, must be less than the total present value of the energy saved over the useful life of the improvements). The mortgage includes the cost of the energy efficient improvements, in addition to the usual mortgage amount normally permitted.

A. <u>Basic Program Requirements.</u>

1. Existing *one- and two-unit* properties are eligible. Three- and four- unit existing properties are not eligible.

2. The cost of any improvement to the property that will increase the property's energy efficiency and that is determined to be "cost effective" is eligible for financing into the mortgage. Its cost may be added to the mortgage amount up to the greater of:

   a. 5 percent of the property's value (not to exceed $8,000); or
   b. $4,000.

   "Cost effective" means that the total cost of the improvements, including any maintenance costs, is less than the total present value of the energy saved over the useful life of the energy improvement. <u>The FHA maximum loan limit for the area may be exceeded by the cost of the energy efficient improvements</u>.

3. The cost of the energy improvements, including maintenance costs, and the estimate of the energy savings must be determined based upon a physical inspection of the property by a home energy ratings system (HERS) representative or energy consultant.

   The HERS representative or energy consultant must be an independent entity; it cannot be related, directly or indirectly, to the seller of the property or the prospective borrower. The contractor selected by the borrower to install the energy efficient improvements may not be related, directly or indirectly, to the HERS representative or energy consultant. The HERS representative or energy consultant may be a utility company; a local, state, or federal government agent; an entity approved by a local, state, or federal government agency specifically for the purpose of providing home energy ratings on residential properties; or a nonprofit organization experienced in conducting home energy ratings of residential properties.

4. The home energy rating report prepared by the HERS representative or energy consultant must be in writing and provided to the prospective borrower and lender. The report must contain the following information:

   a. Address of the property.
   b. Name of the current owner(s) of the property.
   c. Date of the property inspection.
   d. Description of the energy features currently in the property. This description must include, at a minimum, a description of the insulation R values in ceilings, walls and floors; infiltration levels and barriers (caulking, weatherstripping and sealing); a description of the windows (storm windows, double pane, triple pane etc.) and doors; and a description of the heating (including water heating) and cooling systems.
   e. Description of the modifications recommended to improve the energy efficiency of the property.
   f. Estimated costs of the energy improvements, their useful life, and the costs of any maintenance over the useful life.
   g. Present estimated annual utility costs *before* installation of the energy efficient improvements.
   h. Estimated annual utility costs *after* installation of the energy efficient improvements.
   i. Estimated annual savings in utility costs after installation of the energy efficient improvements.
   j. Printed name(s) and signature(s) of the person(s) that inspected the property and prepared the report, as well as the date of preparation of the report.
   k. The following certification statement, signed by the person(s) who inspected the property and prepared the report, must accompany the report:

      "I certify, that to the best of my knowledge and belief, the information contained in this report is true and accurate and I understand that the information in this report may be used in connection with an application for an energy efficient mortgage to be insured by the Federal Housing Administration of the United States Department of Housing and Urban Development."

For streamline refinance transactions, the borrower's monthly payment for principal and interest for the refinance mortgage (which will include the cost for the energy efficient improvements) *must be lower than the monthly principal and interest on the current mortgage*.

B. <u>Escrow Account Specifications.</u> An escrow account may be established for no more than three months after loan closing to allow for installation of the energy efficient improvements. The lender, a utility company, a nonprofit organization, or a government agency may administer the escrow account. The escrow account must be insured and be established at a financial institution supervised by a federal agency.

C. <u>Processing and Underwriting Requirements.</u>

1. The lender will process the mortgage loan application and qualify the borrower using our standard underwriting requirements and qualifying ratios. If the borrower elects to have an EEM and add the cost of the energy efficient improvements to the mortgage, the lender must take the following additional steps:

   a. Obtain a report prepared by a HERS representative or energy consultant showing the estimated costs of installing the energy efficient improvements, including any maintenance costs, and the estimated annual savings in utility costs that will result from the installation of the energy efficient improvements.

   b. Using the HERS or energy consultant's report, the lender must determine that the energy efficient improvements are "cost effective" by calculating the *present cost* of the energy improvements, including maintenance costs (if any) over the useful life of the improvements and the *present value of the energy savings* over the useful life of the energy improvements. If the energy efficient improvements meet the "cost effective" test (i.e., present cost of improvements is less than the present value of the energy savings), the lender may add 100 percent of the cost of the energy efficient improvements (subject to the dollar limits described above in B. 4.) to the otherwise allowable maximum mortgage amount. No appraisal of the energy efficient improvements is necessary, and the borrower need not meet any further credit standards. If the energy efficient improvements meet the "cost effective" test, the full cost of the improvements can be added to the borrower's base loan amount, *without* a determination of value and *without* further credit qualification.

c. The lender calculates the UFMIP on the full mortgage amount, which will include the cost of the energy improvements.

D. **Escrow Account.** We will insure the mortgage before the energy efficient improvements are installed provided the lender establishes an escrow account and deposits into it the funds to pay for the energy efficient improvements. The escrow account shall be for a period of no more than 90 days. If the improvements are not installed within 90 days, the lender must apply the funds held in escrow to a prepayment of the principal balance of the mortgage. The escrow account may be established by the lender and administered by the lender, a utility company, a nonprofit organization, or a government agency. However, the lender is responsible for assuring FHA that the escrow has been cleared. Lenders shall execute Form HUD 92300 Mortgagee Assurance of Completion to indicate that the escrow for the energy efficient improvements has been established. Subsequently, the lender is responsible for notifying FHA that the improvements have been made and that the escrow has been cleared. The installation of the improvements may be inspected by the lender, the HERS, or an FHA fee inspector. The borrower may be charged an inspection fee in accordance with the appropriate HOC fee schedule.

F. **Home Energy Rating Report.** The lender must include a copy of the home energy rating report, performed by the HERS representative or energy consultant, in the closing package, when requesting insurance endorsement.

2-21 **ADVANCE MORTGAGE PAYMENTS PROHIBITED.** We do not permit, as a condition for making a FHA insured mortgage, a lender to collect from the borrower advance payment(s) of the mortgage. Borrowers are not to be required to write post-dated checks, give cash, or otherwise make mortgage payments to the lender in advance of the borrowers mortgage payment requirements under the security instruments.